

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:AOK:OKL:TL-N-668-99
CGMcLoughlin

date: JUL 20 1999

to: Chief, Examination Division, Arkansas-Oklahoma District
Attn: Charles Stanphill

from: District Counsel, Arkansas-Oklahoma District, Oklahoma City

subject: Request for Advisory Opinion

Taxpayer: [REDACTED]

Taxable year: [REDACTED]

DISCLOSURE STATEMENT

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Although we informally coordinated this matter with the National Office, the advisory is subject to the review procedures of CCDM (35)3(19)4(4). The CCDM procedures require us to transmit a copy of the memorandum to the National Office. The National Office has ten days from receipt of our memorandum to respond. The National Office may extend the review period if necessary. We will keep you informed of any delays.

DISCUSSION

We are responding to your February 2, 1999 memorandum concerning a proposal to assert the I.R.C. § 6662(b)(3) substantial valuation misstatement penalty. The penalty would apply to a deficiency attributable to a proposed disallowance of a \$ [REDACTED] loss claimed on [REDACTED] (" [REDACTED] ") consolidated return for the [REDACTED] taxable year. You specifically request our views on: (a) what type of notice must be given to the taxpayer prior to making third party contacts through issuance of summons; (b) whether the I.R.C. § 6664 reasonable cause and good faith defense will preclude imposition of I.R.C. § 6662(b)(3) substantial valuation misstatement penalty under the known facts; and (c) whether the proposed summons language appropriately seeks the information needed to determine if the I.R.C. § 6662(b)(3) substantial valuation misstatement penalty applies here.

Facts

This matter arises out of a [REDACTED] transaction in which [REDACTED] (" [REDACTED] ") sold oil and gas properties to an unrelated party, [REDACTED] (" [REDACTED] "). As consideration for the sale, [REDACTED] received cash and a retained production payment covering the properties. For tax and financial purposes, [REDACTED] valued the production payment at approximately \$ [REDACTED]. A production payment is a right to receive some percentage of production from an oil and gas property, free of production costs, up to a certain dollar amount. The holder has no guarantee of receiving the total amount specified in the production payment. Payments come solely from the property's production. If the property does not have adequate reserves to generate the specified amount over the production payment term, the holder does not receive any other compensation.

[REDACTED] reported the \$ [REDACTED] figure as an amount realized from the sale on its [REDACTED] return. However, we understand reporting the \$ [REDACTED] amount had no real effect on the [REDACTED]'s [REDACTED] tax liability. Apparently, the sale freed up some I.R.C. § 29 credits and some other general tax credits. Those credits absorbed most, if not all of the potential tax liability generated by valuing the production payment at \$ [REDACTED].

In [REDACTED], [REDACTED] acquired all the [REDACTED] stock, terminating the [REDACTED] consolidated group. During [REDACTED] acquisition due diligence, [REDACTED] discovered the production payment was worth, in [REDACTED], a fraction of its \$ [REDACTED] book

value. [REDACTED] took this into account in the [REDACTED] final acquisition price. [REDACTED] also negotiated with [REDACTED] to sell the production payment and rid itself of any interest in the oil and gas properties. [REDACTED] closed the [REDACTED] stock acquisition on [REDACTED]. [REDACTED] then sold the production payment to [REDACTED] for less than \$[REDACTED]. [REDACTED] claimed a loss of approximately \$[REDACTED] on its [REDACTED] return. [REDACTED] had substantial capital gains in [REDACTED] from other transactions and used the \$[REDACTED] loss to offset the capital gains.

Houston Examination Division began looking at the \$[REDACTED] value as part of its [REDACTED] examination for the [REDACTED] taxable year. An outside appraiser hired by Houston Examination Division valued the production payment, in [REDACTED], at less than \$[REDACTED]. The lower value impacts [REDACTED] \$[REDACTED] loss claimed on the [REDACTED] return. Based on some information recently developed by Houston Examination Division, you are considering asserting an I.R.C. § 6662(b)(3) substantial valuation misstatement penalty against [REDACTED] for the [REDACTED] taxable year. You estimate the penalty would be in the range of \$[REDACTED].

To help develop the substantial valuation misstatement penalty issue, you are considering issuing summonses to [REDACTED]'s former tax director and to [REDACTED] ("[REDACTED]"). [REDACTED] is the independent accounting firm which assisted [REDACTED] in preparing its [REDACTED] return and audited [REDACTED]'s [REDACTED] financial statement. The proposed summonses principally seek to identify what information [REDACTED] had in its possession when valuing the production payment on the [REDACTED] return. The proposed summons for the former [REDACTED] tax director will also seek information on what [REDACTED] discovered during the acquisition due diligence process. We understand the former [REDACTED] tax director had some contact with [REDACTED] representatives during the due diligence process. You have already provided [REDACTED] with a Letter 3164, notifying [REDACTED] of your intent to contact third parties.

[REDACTED] seems to admit that it knew the production payment's book value was overstated in [REDACTED]. However, [REDACTED] points out this was true of many other [REDACTED] assets. [REDACTED] discovered this fact while doing its due diligence acquisition audit. After completing the acquisition audit, [REDACTED] and [REDACTED] made adjustments to the [REDACTED] stock acquisition price. [REDACTED] claims there is no evidence the acquisition audit went further and determined the asset was grossly overvalued in [REDACTED].

██████████ also takes the position that it was bound by the inherited tax attributes of ██████████. The company contends that it had no information reflecting the asset was grossly overvalued in ██████████ and the acquisition audit did not focus on this issue. For that reason, ██████████ believes it had reasonable cause and acted in good faith by consistently using ██████████'s tax attributes on the ██████████ return and reporting the \$ ██████████ loss. Given these facts, ██████████ contends the I.R.C. § 6664 reasonable cause and good faith exception precludes imposition of the I.R.C. § 6662(b)(3) substantial valuation misstatement penalty. We understand ██████████ recently proposed to concede the underlying \$ ██████████ loss adjustment if the government does not pursue the substantial valuation misstatement penalty for the ██████████ taxable year.

Analysis

a. Third Party Contacts

Effective January 18, 1999, I.R.C. § 7602(c)(1) prohibits the government from contacting third parties, with respect to the collection or determination of a tax liability, without first providing the taxpayer with reasonable notice that such contacts may be made. I.R.C. § 7602(c)(2) also requires the government periodically to provide the taxpayer with a record of third parties. The proposed summonses to ██████████ and to ██████████'s former tax director are third party contacts covered by I.R.C. § 7602(c).

To implement the new statutory requirements I.R.C. § 7602(c)(1), the government originally began to provide each taxpayer with a Letter 3164 on initiation of an exam. For examinations begun before January 18, 1999, the government provided a Letter 3164 to each taxpayer with an open examination.¹ We understand you already provided ██████████ with a Letter 3164 for the ██████████ taxable year.

If you decide to issue the two proposed summonses, Examination Division will also need to comply with the periodic reporting requirements of I.R.C. § 7602(c)(2). You will need to complete a Form 12175, Third Party Contact Report Form, for each summons and should submit the form to the District Third Party Contact Coordinator. The District Coordinator is responsible for assuring we comply with I.R.C. § 7602(c)(2). However, it might be advisable to give ██████████ oral notification of the summonses.

¹ In mid-March, 1999, the government altered its procedures and now requires a Letter 3164 to be issued when a third party contact is actually pursued.

b. I.R.C. § 6664

I.R.C. §§ 6662(a) and 6662(b)(3) impose a penalty for the portion of any underpayment attributable to a substantial valuation misstatement. The penalty is equal to 20% of the underpayment of tax attributable to a substantial valuation misstatement. A substantial valuation misstatement occurs if:

a. The value or adjusted basis of any property claimed on a return of tax imposed by Chapter 1 is 200% or more than the correct value or adjusted basis; or

b. There is an I.R.C. § 482 valuation misstatement.

I.R.C. § 6662(e)(1).

The statute increases the penalty in the case of a gross valuation misstatement. I.R.C. § 6662(h). The penalty is increased to 40% of the underpayment attributable to the valuation misstatement. I.R.C. § 6662(h)(1). Among other things a gross valuation misstatement occurs if the value or adjusted basis of any property claimed on a return of tax imposed by Chapter 1 is 400% or more than the correct value or adjusted basis. I.R.C. § 6662(h)(2)(A)(i).

No penalty will be imposed unless the portion of the underpayment attributable to a substantial valuation misstatement exceeds \$5,000 (or \$10,000 in the case of a corporation other than an S corporation or a personal holding company). I.R.C. § 6662(e)(2). Unlike other I.R.C. § 6662 penalties, a taxpayer cannot avoid I.R.C. § 6662(b)(3) by disclosing a substantial valuation misstatement on a return. Treas. Reg. § 6662-5(a). But, the penalty does not apply to the extent there was reasonable cause for the substantial valuation misstatement and the taxpayer acted in good faith with respect to the underpayment. I.R.C. § 6664(c)(1).

Treas. Reg. § 1.6664-4(b)(1) provides that the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis. In making the determination, all pertinent facts and circumstances must be taken into account. Id. Generally, the most important factor is the steps the taxpayer took to assess the proper tax liability. Id. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law which is reasonable in light of the facts and circumstances, including the experience, knowledge and education of the taxpayer. Id. Reliance on an information return, the advice of a tax advisor or on facts that, unknown to the taxpayer, are incorrect may or may

not constitute reasonable cause and good faith depending on whether the reliance was reasonable under the facts. Id.

Here, there is no question that a gross valuation misstatement occurred on [REDACTED] return. The \$ [REDACTED] basis used to claim the [REDACTED] loss exceeded the true basis for the production payment by more than 400%. The deficiency generated by the claimed loss exceeded the \$10,000 threshold under I.R.C. § 6662(e)(2). Consequently, [REDACTED] will be liable for the substantial valuation misstatement penalty unless reasonable cause and good faith can be shown under I.R.C. § 6664(c)(1). However given the evidence available to government at this time, we would have some difficulty contesting [REDACTED] reasonable cause and good faith defense.

In analyzing [REDACTED] reasonable cause and good faith defense, the key factual issues would be: (a) what did [REDACTED] know about the [REDACTED] overstated value when it filed the [REDACTED] return; and (b) what steps did [REDACTED] take to investigate whether the book values had some factual basis. In all likelihood to sustain the I.R.C. § 6662(b)(3) penalty, the government will have to demonstrate a fairly high level of knowledge on [REDACTED] part concerning the [REDACTED] valuation problems. At this point in time, there is insufficient evidence to show [REDACTED] was aware of the [REDACTED] valuation problem.

From the currently available information, we know that [REDACTED] recognized the [REDACTED] book value was substantially overstated. [REDACTED] examined the book value of the production payment during the acquisition audit and determined it did not reflect the production payment's current value. [REDACTED] also confirmed that the book value was overstated by selling the production payment to [REDACTED] for less than \$ [REDACTED]. Nonetheless, we have no evidence that [REDACTED] looked further and determined the production payment had been substantially overvalued on [REDACTED]'s [REDACTED] return.

[REDACTED] might have some exposure for the penalty by failing to look further after discovering the [REDACTED] book value problem. In view of the great disparity between the book value and the fair market value, a court might impose a duty on the taxpayer to make a further inquiry. This scenario is unlikely to prevail here.

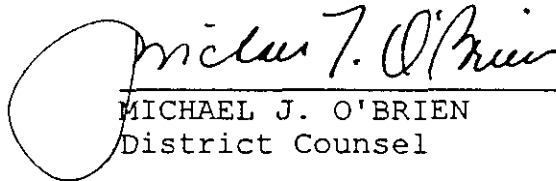
[REDACTED] could easily counter that it is very common to find overstated book values (including substantial deviations between book value and fair market value) in acquisition audits. [REDACTED] could also point out that [REDACTED] had issued clean [REDACTED] and [REDACTED] opinions for [REDACTED]. The existence of the

audits and the frequency of finding book and fair market value deviations would be persuasive in many courts. Consequently, the government is unlikely to prevail here unless we can show [REDACTED] had significant information in [REDACTED] regarding the [REDACTED] valuation problem.

c. Proposed Summons

Although we have no problem with the language of the proposed summons, we question whether the summons will develop the information needed to sustain the penalty. Both summonses principally ask about [REDACTED]'s knowledge when valuing the property in [REDACTED]. Neither focus on the more crucial issue in the examination, [REDACTED] knowledge in [REDACTED], of the [REDACTED] valuation problem.² This crucial information might be more readily obtained directly from [REDACTED].

Please contact Glenn McLoughlin at (405) 297-4803 if you have any questions.


MICHAEL J. O'BRIEN
District Counsel

cc: ARC (TL) & ARC (LC),
Midstates Region

² We recognize that [REDACTED]'s former tax director was involved with the [REDACTED] due diligence audits. He may have information concerning disclosures made to [REDACTED] of the [REDACTED] valuation problem.